

# **STARTING A BUSINESS IN NEVADA**

**BY**

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# STARTING A BUSINESS IN NEVADA

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## INTRODUCTION

Starting a new business is an exciting and complicated endeavor. Besides the market research and financing aspects of forming the business, the more mundane acts of actually setting up the business must be undertaken. It is important that the business be organized to reflect the desires of the owners, not just in terms of running the day-to-day activities of the business, but also regarding such future events as the sale of all or part of the business, the acquisition of another business, the death, divorce or bankruptcy of an owner, or the liquidation of the business. It is with these more mundane activities in mind that this guide is written.



This guide is not to be considered a substitute for the advice of counsel. No decisions should be made based solely on the information contained herein.<sup>1</sup>

## WHICH BUSINESS FORM?

Selecting the form in which to operate a business is one of the most significant decisions an owner will have to make with respect to that business.

The choice of business form can have broad implications, not only for the manner in which the enterprise will be conducted, but for the personal affairs of the owner. For instance, the choice of business form can directly affect the decision about what property the client will contribute to the business, whether the owner or the business will be responsible for the business' obligations, whether, and in what form, the business will continue after the client has ceased to participate in it, how interests in the business may be transferred and other participants brought in (or allowed out), how the owner's personal income tax liability will be calculated, and what the client's optimum estate plan should be.

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<sup>1</sup> This is only a brief overview of alternative business styles and general considerations when starting a business. It is not a comprehensive or thorough discussion of all possible choices. Your choice must be made with the help of counsel who can evaluate your circumstances and make recommendations based on those circumstances.

The choice of business form will also have a significant impact upon the relative complexity or simplicity of the client's legal and financial affairs and upon the degree of financial risk to which the owner(s) will be exposed.

Making a sound decision on the choice of business form, therefore, often requires the owner to look beyond his or her current business situation to examine such matters as the business' long and short term prospects, as well as the general tax and financial affairs of the owner and, in many cases, those of the owner's family and business associates.

There are a number of basic forms of business presently in Nevada but there are really six (6) that are worth discussing at this time -- Sole Proprietorship, General Partnership, Limited Partnership, "C" Corporation, "S" Corporation and Limited Liability Companies. Each form has various advantages and disadvantages.

In the following sections, this guide offers a brief introduction to and summary of the advantages and disadvantages of each form of business.

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## **SOLE PROPRIETORSHIP**

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A proprietorship is the basic form which an individual can use for operating a business. A sole proprietorship is not a legal entity separate and apart from its owner. No organizational documents are needed to operate as a sole proprietorship. A proprietorship is simple in that it does not require any formal action to set it up or any filings with the Nevada Secretary of State.<sup>2</sup>

The operation of a sole proprietorship is solely within the owner's discretion, subject to the relevant governmental regulations. No special formalities are required. The net income or loss, as well as any credits, or other tax items of the business, are passed through directly to the sole proprietor, and reported on a Schedule C to the sole proprietor's individual income tax return.

Since a proprietorship is simply an individual using assets to conduct a business, the sale of the proprietorship is accomplished by selling the assets used in the business.

Termination of a proprietorship is simple -- the owner simply stops conducting the business or files bankruptcy.

### **ADVANTAGES AND DISADVANTAGES OF SOLE PROPRIETORSHIPS**

#### **Advantages of Sole Proprietorships**

- 1) Simplicity – No significant government regulatory requirements that apply specifically to sole proprietorships.
- 2) No entity level of Federal Income Tax on Earnings.
- 3) No State or Federal Unemployment taxes on the earnings of the owner since the owner is not ordinarily deemed to be an “employee” of the business.

#### **Disadvantages of Sole Proprietorships**

- 1) Unlimited liability of the owner.
  - 2) Less favorable Federal Income Tax Deductions for Health Insurance and other benefits to the owner.
  - 3) Need to attach a Schedule C form to the owner's individual tax return.
  - 4) Owner must pay self-employment tax pursuant to Schedule SE.
  - 5) Only the owner can act on behalf of the business, unless other agents are used.
  - 6) Limited Life – the business is subject to dissolution upon the owner's death.
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<sup>2</sup> Other than bank accounts, business license, fictitious firm name statement, etc.

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## **GENERAL PARTNERSHIP**

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A general partnership is an association of two or more persons to carry on a business for profit as co-owners.<sup>3</sup> A partnership is the basic non-entity form in which two or more owners can operate a business. The owners can be individuals, corporations, estates, trusts, or other legal entities. Although it is strongly advised, a partnership is not dependent on a formal written agreement.

Though the partnership itself is not a separate legal entity (the partners, not the partnership are personally liable for the partnership liabilities) a partnership has a quasi-entity status for tax purposes since the partnership must file an informational tax return with the IRS. Additionally, tax items such as income and deductions are determined at the partnership level, and then passed through to the partners' tax returns.

The transferability of a partnership interest is limited. Absent a provision in the partnership agreement to the contrary, a partnership interest cannot be transferred without the unanimous consent of the other partners. It is unlikely that the partners would allow free transferability in the partnership agreement, since they would not want to have an unknown person thrust on them as a partner.

The sale of a partnership interest will generally produce a capital gain or loss, measured by the difference between the amount realized and the selling partner's basis in the partnership.

Under Nevada law, a partnership is technically "dissolved" on the occurrence of various events, including the death or withdrawal of a partner. However, the remaining partners ordinarily may continue the partnership business as a new partnership.

### **PARTNERSHIP AGREEMENT**

The basic governing document of a partnership is the partnership agreement. Generally, a partnership is operated in whatever manner the agreement provides. The Nevada statutes provide rules to cover aspects of partnership management and operation that are not provided by the partnership agreement. The most important provisions of the partnership agreement include the buy-sell provisions (in the event a partner wants out) and the profit allocation provisions.

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<sup>3</sup> NRS §87.060.

## **ADVANTAGES AND DISADVANTAGES OF GENERAL PARTNERSHIPS**

### **Advantages of General Partnerships**

- 1) Simplicity -- cheap and easy to organize.
- 2) No entity level of Federal Income Taxes on earnings -- accordingly, no double taxation.
- 3) No state and federal unemployment and SIIS taxes on earnings of partners, since like a proprietorship, a partner is not generally deemed to be an employee of the partnership.
- 4) Tax basis rules more generous than for an S-Corporation.
- 5) Greater flexibility in allocating income among partners.
- 6) All partners generally have management ability.
- 7) Generally, no taxable gain or loss on contributions or distributions.

### **Disadvantages of General Partnerships**

- 1) Unlimited liability of the owners.
  - 2) No continuity of life -- upon the death or bankruptcy of a partner, the partnership dissolves.
  - 3) Less favorable Federal Income Tax deductions for health insurance and other benefits provided to partner(s).
  - 4) Potentially greater exposure for alleged breach of fiduciary duty since there is no provision comparable to NRS §78.037 (allowing for limitation of personal liability of directors, officers and shareholders of a corporation).
  - 5) Partners may have to pay self-employment tax on their share of the partnership's self-employment income per Schedule SE.
  - 6) Partnership must file information return Form 1065 with the IRS.
  - 7) One partner may obligate the others (and the business).
  - 8) All partners are liable for the actions of another partner acting on behalf of the partnership
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## **LIMITED PARTNERSHIPS**

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The limited partnership is substantially identical to the general partnership in legal form. The difference is that limited partnerships have at least one, and usually more, "limited partners." A limited partner is often an investor whose liability for partnership obligations is limited to his or her contribution, share of any recourse debt, and obligation to make future contributions.

A general partner in a limited partnership has unlimited liability for the debts and obligations of the partnership.<sup>4</sup>

A limited partner's liability is limited to the amount of cash or property contributed by the limited partner and the amount required to be contributed under the terms of the agreement of limited partnership.<sup>5</sup> However, a limited partner who participates in management in any significant way may lose their limited liability status if a creditor can prove that it knew of the "control behavior" and reasonably believed that the limited partner was liable as a general partner.

However, a limited partner is permitted to consult with and advise the general partner, act as a surety or guarantor of partnership debts, or own or direct a corporate general partner. A limited partner may also lend money to the partnership without automatically having to subordinate their loans to those of other creditors.

For tax purposes, limited partnerships provide their general partners the same tax benefits as general partnerships. Limited partners, however, are subject to the "passive activity" limitations of IRC §469, which largely prevents limited partners from benefiting from the limited partnership's tax credits and tax losses. Because of this, limited partnerships are not generally useful as tax shelters.

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<sup>4</sup> NRS §88.455.

<sup>5</sup> NRS §88.430.

## **ADVANTAGES AND DISADVANTAGES OF LIMITED PARTNERSHIPS**

### **Advantages of Limited Partnerships**

- 1) Limited liability for the limited partner(s).
- 2) No entity level of Federal Income Taxes on earnings -- accordingly, no double taxation.
- 3) No state and federal unemployment and SITS taxes on earnings of partner(s).
- 4) Tax basis rules more generous than for S Corporation.
- 5) Greater flexibility in allocating income among partners.

### **Disadvantages of Limited Partnerships**

- 1) Unlimited liability for general partner(s).
  - 2) No continuity of life -- upon the "withdrawal" of a general partner, the partnership may be dissolved. Events of "withdrawal" may include bankruptcy, death, and incompetency.
  - 3) Less favorable Federal Income Tax deductions for health insurance and other fringe benefits provided to partner(s).
  - 4) Must comply with Securities laws .
  - 5) Potentially greater exposure for alleged breach of fiduciary duty as there is no provision comparable to NRS §78.037 (allowing for limitation of personal liability of directors, officers or shareholders of a corporation).
  - 6) The partnership must file a Certificate of Limited Partnership with the Secretary of State. Failure to file the Certificate results in the entity being classified as a general partnership.
  - 7) Limited management by limited partners.
  - 8) More complex than general partnership.
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## **"C" CORPORATION**

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Corporations are creatures of state law and accordingly must satisfy certain formal requirements for legal recognition. Nevada law does not govern whether a corporation is to be treated under Subchapter "C" or Subchapter "S" of the Internal Revenue Code (the "IRC"). By default, all corporations are deemed to be taxed under Subchapter "C" of the IRC. The owners must opt out of Subchapter "C" by the filing of a Form 2553 with the IRS in order to be taxed under Subchapter "S".

Ownership of the corporation is evidenced by corporate stock. A "C" Corporation may issue various types of stock for the purpose of allocating control or varying the nature of the various shareholders' potential risks and return on investment. The most frequently used classes of stock are "common" and "preferred." Common Stock ordinarily represents potential growth while the Preferred Stock may allow for a more predictable return on investment.

The "C" corporation offers maximum flexibility in allocating control and varying the nature of the shareholders' equity in the corporation.

A corporation is a separate legal entity from its owners (shareholders) and is managed and controlled by directors and officers. Fundamental corporate policy is set by the board of directors while responsibility for the day-to-day operation of the corporation rests on the President. All corporations must have a President, Secretary and Treasurer. Additionally, corporations may have multiple Chief Officers, Vice Presidents and Assistant officers.

As a separate entity for tax purposes, the corporation reports all income, losses, deductions, and credits on a corporate income tax return and pays tax at the corporate rates prescribed in the IRC. Shareholders are not taxed unless they receive dividends or other distributions. Of course, shareholders may also be employees and, as such, are taxed on their compensation income (which is deducted from the corporation).

Of all the forms of business organizations, corporations have the most freely transferable interests. Also, the transfer is the least complicated for tax purposes. Since corporate stock represents each owner's equity in the corporation, the transfer is achieved by transferring the stock. In closely held corporations, restrictions on transfer are often imposed, usually by means of an option, or right-of-first-refusal.

For tax purposes, a transfer has no effect on the corporation itself and no effect on the shareholders who are not parties to the transfer. Upon the sale of stock, the selling shareholder realizes a capital gain or loss to the extent of the difference between the amount realized for the stock and the adjusted basis in the stock.<sup>6</sup> The buyer takes a basis equal to the cost, including expenses of purchase, such as legal fees and brokerage commissions.

A corporate termination (also known as a liquidation or dissolution) generally occurs only in the case of closely held corporations or publicly held corporations that have failed. A liquidation is a corporate act requiring shareholder approval.

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<sup>6</sup> IRC §§ 1011,1011,1221.

A corporate liquidation is generally a taxable event for both the liquidating corporation and its shareholders. The corporation will generally recognize any gain or loss on the difference between the amount realized and its basis in the assets. Similarly, the shareholders will recognize any gain or loss on the difference between the amount realized and their basis in the stock

The corporation offers protection against personal liability. Limited liability in a corporation can be lost by the "piercing of the corporate veil" due to "thin" capitalization or failure to follow appropriate legal formalities in operating the corporation.

The principal non-tax disadvantage of the corporate form (whether a C or S corporation) is that it entails more formalities, closer supervision by regulatory bodies, and greater administrative expense than do the non-corporate forms.

### **INCORPORATION**

For a business to exist in corporate form, it must file its articles of incorporation with the Secretary of State. A Registered Agent must execute and file a certificate of acceptance of appointment with the secretary of state.<sup>7</sup> By the end of the month following the incorporation, the new corporation must then file, also with the Secretary of State, a list of its officers and directors and a designation of its Registered Agent. At the time of organization the corporate bylaw and organizational minutes will be prepared and executed so the corporation and its officers will have the authority to conduct corporate business. The corporate bylaws are, essentially, the written rules under which the corporation will operate.

### **SHAREHOLDER'S AGREEMENT**

Just as the bylaws are the written rules under which the corporation will operate, the Shareholder's Agreement contains the written rules under which the shareholders will conduct themselves. Included in the shareholder's agreement are such things as the buy-sell provisions whereby a procedure is designated for the buy-out of a selling shareholder. These provisions are important as much for the remaining shareholder as for the selling shareholder since they may govern to whom the shares may be sold and at what price.

### **CORPORATE MAINTENANCE AND RECORD KEEPING**

Nevada law requires that the corporation must make a yearly filing of a list of its officers and directors and a designation of its Registered Agent in the state. If the corporation fails to file this yearly report, the corporation may: (1) lose its right to transact any business in the State of Nevada<sup>8</sup>, (2) forfeit its charter, and (3) distribute the corporation's assets.<sup>9</sup>

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<sup>7</sup> NRS §78.030.

<sup>8</sup> NRS §78.170.

<sup>9</sup> NRS §78.175.

## **ANNUAL MEETING OF THE SHAREHOLDERS**

Since a corporation is ultimately responsible to its shareholders, the law requires a shareholder consensus for fundamental corporate actions that are beyond the powers of the directors and officers. Actions typically requiring shareholder approval include the election of directors, adoption or amendment of the bylaws, amendment of the articles of incorporation, merger or consolidation of the corporation, sale or mortgage of substantially all of the corporation's assets, or dissolution of the corporation.

Shareholder approval is acquired in one of two ways, either by a vote at a meeting of the shareholders or by written consent of the shareholders in lieu of a meeting. Shareholders must act collectively, as opposed to individually, and may only act at a properly called shareholders' meeting or by consent action in lieu of this meeting.

A failure to hold the annual meeting at the designated time or to elect a sufficient number of directors to conduct the corporation's business will not ordinarily mean that the corporation automatically dissolves. Further, any stockholder or director may petition the courts for an order requiring the holding of an annual meeting if none has been held within 30 days of the date designated or if 13 months have elapsed since the corporation's organization or last annual meeting.

"Special" shareholders' meetings may typically be called by the board of directors or by persons authorized in the articles of incorporation or bylaws. Generally, any corporate business may be conducted at the annual meeting. At a special meeting, however, the corporation may generally only deal with the business specified in the notice of meeting.

Business may not be conducted at a shareholders' meeting unless a quorum is present. Quorum requirements are typically set forth in the bylaws and must comply with all relevant statutes. A majority of shareholders in attendance may adjourn a shareholder's meeting.

## **DIRECTORS - DUTIES AND LIABILITIES**

All corporations are required to have at least one director. The number of directors may be increased or decreased in such manner as provided in the articles of incorporation or bylaws. Unless otherwise provided in the articles of incorporation, directors need not be stockholders.

In case of willful or negligent violation of the statutes as to dividends or distributions to stockholders, the directors who did not properly oppose the violation are personally liable at any time up to three years.<sup>10</sup> Directors may also be liable for fraudulently conveying property against the interest of creditors<sup>11</sup> and for making false reports.<sup>12</sup>

In Nevada, it is possible to include a provision in the articles of incorporation to limit or even eliminate personal liability of a director (or officer) to the corporation or its stockholders for damages

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<sup>10</sup> NRS §78.300.

<sup>11</sup> NRS §78.625.

<sup>12</sup> NRS §78.145.

resulting from a breach of fiduciary duty.<sup>13</sup> Such a provision, however, does have certain statutory limitations.<sup>14</sup>

Subject to restrictions contained in the statutes, a corporation may indemnify any person made or threatened to be made a party to any threatened, pending or complete action, suit or proceeding by or in the right of the corporation or other than by or in the right of the corporation by reason of the fact that he or she is or was a director, officer, employee or agent of the corporation.<sup>15</sup>

Additionally, a corporation may be able to purchase indemnification and liability insurance to protect its directors (and officers)<sup>16</sup> or make other financial arrangements for their protection.<sup>17</sup>

### **STOCK ISSUED WITH RESTRICTIONS**

It may be desirable to issue stock to employees as incentive compensation. Stock may be issued to employees subject to certain conditions where until the conditions expire, the employee's right to the share is subject to substantial risk of forfeiture. For instance, the stock may not be transferred and must be sold back to the corporation at the original grant price if the employee terminates employment within the specified period.

### **QUALIFICATION TO DO BUSINESS IN FOREIGN JURISDICTION**

Most states require out-of-state corporations to "qualify," i.e., to register and pay taxes if they "transact business" within that state. Typically, other states require the "qualifying" corporation to file a copy of the articles of incorporation with the secretary of state, file a formal application for qualification to transact business in another state, and pay the appropriate filing fee and required taxes. It is also important to check with the appropriate agencies for the ability to transact business in the corporation's name.

### **WHAT MUST BE ON FILE AT REGISTERED OFFICE**

Nevada law requires that every corporation must keep at its registered office a certified copy of its certificate of incorporation or articles of incorporation along with all amendments, a certified copy of its bylaws along with all amendments, and a stock ledger containing information about all shareholders or a statement regarding the whereabouts of the stock ledger.<sup>18</sup>

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<sup>13</sup> NRS §78.037(1).

<sup>14</sup> *Id.*

<sup>15</sup> NRS §78.751.

<sup>16</sup> NRS §78.752.

<sup>17</sup> *Id.*

<sup>18</sup> NRS §78.105.

## **PRE-EMPTIVE RIGHTS**

For corporations organized on or after October 1, 1991, absent a contrary provision in the articles of incorporation, no stockholder has the right to purchase his prorata share of new stock at the cash price offered to others.<sup>19</sup>

## **SECURITIES LAWS**

When forming a corporation, the issuance of shares to the shareholders must comply with both federal and Nevada securities laws. If the issuance is made improperly, the organizers of the corporation may be made a target for lawsuits from discontented investors in the corporation. Additionally, the organizers may be subject to criminal prosecution.

Typically, the business will be able to qualify for exemptions from the procedures of registering with the SEC under the federal securities laws or "qualifying" with the Nevada Secretary of State under Nevada's securities laws, however, the issuance of stock must be carefully orchestrated.

## **CHARGING ORDER PROTECTION**

In essence, a Charging Order allows a judgment creditor to receive such distributions from certain forms of companies (e.g., partnerships, limited-liability companies and now, certain Nevada corporations) as a judgment debtor would have received. It is important to note that a judgment creditor does not have access to the company's assets and has no management or voting rights.

There are important points relating to Charging Orders:

- (1) the charging order is a lien against the judgment debtor's interest and does not allow the judgment creditor to foreclose against the debtor's interest;
- (2) the creditor cannot exercise any management or voting rights because the creditor has "only the rights of an assignee of the stockholder's stock" pursuant to the new (as yet unnumbered) section;
- (3) the creditor has no other remedies available but the charging order

### **Charging Orders and Single Shareholder Corporations**

In *re: Ashley Albright*, a Bankruptcy Court in Colorado<sup>20</sup> held that a the charging order protection does not apply to single-member LLCs since, the Court held, charging orders were intended to protect non-debtor "partners," and in single-member LLCs there is no one to protect. As the language of the Colorado LLC statutes does not exempt single-member LLCs from the protection of the charging order and so, many attorneys are uncertain as to the true applicability of *Albright*.

In community property states, a Court following *Albright* would probably treat a married couple as a single member and thus would likely not afford the owners of the charging order protection.

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<sup>19</sup> NRS §78.265.

<sup>20</sup> In *re: Ashley Albright*, No. 01-11367 (Bkrptc. D. Col. 04/04/2003), United States Bankruptcy Court for the District of Colorado

## **ADVANTAGES AND DISADVANTAGES OF "C" CORPORATIONS**

### **Advantages of "C" Corporation**

- 1) Limited liability of the owners.
- 2) Continuity of life of the business entity.
- 3) Ease of transferability of ownership interests.
- 4) Flexibility of ownership interests.
- 5) More favorable Federal Income Tax deductions for health insurance and other fringe benefits to owner/employee.
- 6) Can limit personal liability of officers and directors for breach of fiduciary duty under NRS §78.037.
- 7) Can issue more than one class of stock.
- 8) No limitations on the number or qualifications of the shareholders.
- 9) IRC §1244 stock may be issued if a corporation qualifies. Section 1244 Stock allows a loss on disposition to be "ordinary" instead of "capital" in character.
- 10) Fiscal year accounting may be available.
- 11) Charging Order Protection may be available

### **Disadvantages of "C" Corporation**

- 1) Corporate maintenance requirements and formality adherence.
- 2) Entity level of Federal Income Tax on earnings -- therefore, double taxation. Corporations are taxed on earnings, then shareholders are taxed on dividends. The corporation must file Federal Income Tax returns on Form 1120 and state income or franchise tax returns in most states where it does business.
- 3) Dual roles for shareholders.
- 4) Higher payroll taxes for owner / employee.
- 5) Taxes due upon liquidation of the corporation.
- 6) A corporation incorporated in a state other than the one in which it is conducting business must qualify with the Secretary of State to do business.
- 7) Corporation may be liable for alternative minimum, accumulated earnings, or personal holding company taxes.

## **"S" CORPORATION**

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An "S" corporation is identical to a "C" corporation for most non-tax purposes. For tax purposes, "S" corporations and "C" corporations differ dramatically. Whereas a "C" corporation is a separate entity for tax purposes, an "S" corporation is a flow through entity much like a partnership.

Once the owner has made the decision to incorporate, the choice of "S" corporation status is most often made for either or both of the following reasons: simplicity and pass-through of tax items. It is critical to file the "S" corporation election in a timely manner. It may be desirable to use "S" corporation status in early (loss) years of a corporation and then convert to a "C" corporation when the corporation becomes profitable.

An "S" corporation is organized in the same way as a "C" corporation and the tax aspects of organization are the same.

Only certain corporations, called "small business corporations," are eligible to be "S" corporations. The term "small" may be misleading, because there is no limit on income or assets. The limit is on the number of shareholders, which presently cannot exceed 75. Other limitations on eligibility exist. All shareholders must consent to the "S" corporation election.

Once organized, the operation of an "S" corporation for non-tax purposes is identical to that of a "C" corporation. The difference between the two is in the manner of taxation. The taxation of "S" corporations and shareholders is quite similar to the taxation of partnerships and partners. With the exception of certain capital gains and certain "passive" income, the corporation is not generally taxed. Instead, items of income, loss, deduction and credit are passed through to the shareholder. Also, tax items retain their character (i.e., as "ordinary" or "capital" items) in the shareholders' hands.

The pass-through of tax items occurs regardless of whether the corporation makes any distributions to shareholders. On the other hand, actual distributions are non taxable to the extent of the recipient's basis. The amount of a distribution reduces the recipient's basis in the stock. Distributions exceeding shareholder basis are taxed as capital gains.

The tax and non-tax aspects of transfers of "S" corporation interests are substantially identical to a "C" corporation. The tax difference between transfers of "S" and "C" corporation stock is the result of the "S" corporation's pass-through-entity status.

The non-tax aspects of the termination of "S" corporations and "C" corporations are substantially the same. The tax treatment is significantly different, however, because generally only a single level of tax is imposed when an "S" corporation terminates, whereas double taxation may result from the termination of a "C" corporation. Also, if the "S" corporation has accrued income that has not been distributed to the shareholders, the income will be taxable to them and will increase their stock basis, with the result that the liquidation distribution will produce less taxable gain to the shareholders than a comparable liquidation of a "C" corporation.

## **CHARGING ORDER PROTECTION**

In essence, a Charging Order allows a judgment creditor to receive such distributions from certain forms of companies (e.g., partnerships, limited-liability companies and now, certain Nevada

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corporations) as a judgment debtor would have received. It is important to note that a judgment creditor does not have access to the company's assets and has no management or voting rights.

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- (2) the creditor cannot exercise any management or voting rights because the creditor has "only the rights of an assignee of the stockholder's stock";
- (3) the creditor has no other remedies available but the Charging Order.

### Charging Orders and Single Shareholder Corporations

In *In re: Ashley Albright*, a Bankruptcy Court in Colorado<sup>21</sup> held that a the charging order protection does not apply to single-member LLCs since, the Court held, charging orders were intended to protect non-debtor "partners," and in single-member LLCs there is no one to protect. As the language of the Colorado LLC statutes does not exempt single-member LLCs from the protection of the charging order and so, many attorneys are uncertain as to the true applicability of *Albright*.

In community property states, a Court following *Albright* would probably treat a married couple as a single member and thus would likely not afford the owners of the charging order protection.

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<sup>21</sup> In re: Ashley Albright, No. 01-11367 (Bkrptc. D. Col. 04/04/2003), United States Bankruptcy Court for the District of Colorado

## **ADVANTAGES AND DISADVANTAGES OF "S" CORPORATIONS**

### **Advantages of "S" Corporation**

- 1) Limited liability of owners.
- 2) Continuity of life.
- 3) No entity level of Federal Income Tax on earnings -- therefore no double taxation. However, the "S" corporation must prepare and file Form 1120-S with the IRS.
- 4) Ease of transferability of ownership interests as compared to Proprietorship and Partnerships.
- 5) Can limit personal liability of officers and directors for breach of fiduciary duty under NRS §78.037.
- 6) Corporate alternative minimum, accumulated earnings and personal holding tax do not apply.
- 7) No self employment tax on dividend distributions.
- 8) Charging Order Protection Available

### **Disadvantages of "S" Corporation**

- 1) Corporate maintenance requirements and formality adherence.
- 2) Dual role of shareholders.
- 3) Limitations on number and type of permissible shareholders.
- 4) Limitations on permissible classes of stock.
- 5) Tax basis rules less generous than for partnerships.
- 6) Less favorable Federal Income Tax deductions for fringe benefit purposes (including health insurance) as compared to a "C" corporation" since an "S" corporation is treated as a partnership.
- 7) Possible limitations on debt issuance.
- 8) Securities laws compliance.
- 9) Higher payroll taxes for owner-employee.
- 10) No special allocation of income is permitted compared to partnerships.

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## **LIMITED LIABILITY COMPANY**

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### **GENERALLY**

Limited Liability Companies ("LLC") are a relatively new form of business entity and is somewhat of a hybrid between a partnership and a "S" corporation. LLC's provide a partnership's flexibility of operations with the limitation of personal liability on its owners as in a corporation.

The LLC's tax benefits come from the partnership tax rules. Accordingly, it avoids certain ownership restrictions that may exist within the "S" corporation tax rules.

An owner of an LLC is called a "Member". LLC's can be managed by the Members or preferably, by "Managers" appointed by the Members.

### **ATTRIBUTES OF AN LIMITED LIABILITY COMPANY ("LLC")**

#### **LLC'S V. "C" CORPORATIONS**

As mentioned in a prior section, a shareholder of a "C" corporation is subject to a double level of tax: first at the corporate level and then, when dividends are paid, at the shareholder level. A LLC is a "flow-through" entity and owners are taxed as if the LLC were a partnership.

"C" corporation shareholders cannot deduct corporate losses. Again, being a "flow-through" entity means that any business losses pass through to the owner of a LLC who is able to deduct the business loss.

Lastly, a "C" corporation may be subject to accumulated earnings tax or personal holding company taxes. Since a LLC is not governed by Subchapter "C", there is no accumulated earnings tax or personal holding company tax and accordingly, there is no restriction on the amount of investment income an LLC can receive relative to its active business income.

#### **LLC'S V. "S" CORPORATIONS**

The tax rules governing "S" corporations are restrictive regarding the number and characteristics of its shareholders. For instance, a "S" corporation can not have over 75 shareholders, and the shareholder can not be another corporation, a partnership, a nonresident alien, a non-qualified trust, a pension plan or a charitable organization. LLC's have no such ownership restrictions.

An "S" corporation cannot have more than one class of stock. A LLC can have multiple ownership classes which may allow for a special allocation of tax attributes.

If a corporation is converted to an LLC, the IRS treats it as a termination of the corporation. Therefore, there may be significant tax implications to the corporation and its shareholders.

#### **LLC'S V. PARTNERSHIPS**

General Partnerships. Partnerships and LLC's have the same ability to make special allocations of tax attributes. However, LLC's liabilities are always nonrecourse and must be allocated according to the partners' interests in the partnership (i.e., reasonably consistent with allocations of some other

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significant partnership items).

**Limited Partnerships.** As mentioned in the section dealing with Limited Partnerships, Limited Partners who participate in management of limited partnership risk loss of limited liability status. There is no problem with a LLC owner materially participating in the management of an LLC. In fact, it is recommended that an owner materially participate in order for any LLC losses to be considered nonpassive to the owner.

If a partnership is converted to an LLC, the IRS does not treat it as a termination of the partnership and, accordingly, there are no tax implications of such a conversion.

### **PASSIVE LOSS RULES**

Since members of LLC's may participate in management without loss of their limited liability status, losses of an LLC to participating members is nonpassive.

### **CHARGING ORDER PROTECTION**

In essence, a Charging Order allows a judgment creditor to receive such distributions from certain forms of companies (e.g., partnerships, limited-liability companies and now, Nevada corporations) as a judgment debtor would have received. It is important to note that a judgment creditor does not have access to the company's assets and has no management or voting rights.

There are important points relating to Charging Orders:

- (1) the charging order is a lien against the judgment debtor's interest and does not allow the judgment creditor to foreclose against the debtor's interest;
- (2) the creditor cannot exercise any management or voting rights because the creditor has "only the rights of an assignee of the member's interest;
- (3) the creditor has no other remedies available but the Charging Order.

### **Charging Orders and Single Member LLCs**

In *In re: Ashley Albright*, a Bankruptcy Court in Colorado<sup>22</sup> held that a the charging order protection does not apply to single-member LLCs since, the Court held, charging orders were intended to protect non-debtor "partners," and in single-member LLCs there is no one to protect. As the language of the Colorado LLC statutes does not exempt single-member LLCs from the protection of the charging order and so, many practitioner's are uncertain as to the true applicability of Albright.

In community property states, a Court following *Albright* would probably treat a married couple as a single member and thus would likely not afford the owners of the charging order protection.

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<sup>22</sup> In re: Ashley Albright, No. 01-11367 (Bkrptc. D. Col. 04/04/2003), United States Bankruptcy Court for the District of Colorado

## **ADVANTAGES AND DISADVANTAGES OF A LIMITED LIABILITY COMPANY**

### **Advantages of a Limited Liability Company**

- 1) Limited liability of owners.
- 2) No entity level of Federal Income Taxes on earnings -- accordingly, no double taxation.
- 3) No state and federal unemployment taxes on earnings of members, since like a partnership, a member is not generally deemed to be an employee of the partnership.
- 4) Tax basis rules more generous than for an S Corporation.
- 5) Greater flexibility in allocating income among members.
- 6) All members generally have management ability.
- 7) Generally, no taxable gain or loss on contributions or distributions.
- 8) Minimal limitations on the number or qualifications of the members.
- 9) Multiple ownership classes are possible.
- 10) Charging Order Protection Available

### **Disadvantages of a Limited Liability Company**

- 1) Less favorable Federal Income Tax deductions for health insurance and other benefits provided to members.
- 2) Members may have to pay self-employment tax on their share of the LLC's self-employment income per Schedule SE.
- 3) LLC must file information return Form 1065 with the IRS.
- 4) LLC maintenance requirements and formality adherence.

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## **ISSUES AFFECTING ALL FORMS OF BUSINESS**

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There are a number of issues that affect all businesses, no matter their form.

### **NEVADA ISSUES**

#### **BUSINESS LICENSES**

Prior to starting a business, the owner should determine the necessary licensing requirements by contacting the appropriate licensing agency. The State of Nevada, as well as the counties and municipalities may have licensing requirements. If in doubt as to whether a business license is required, a good source of information may be the county clerk's office or the Business License Division.

The State of Nevada requires all businesses operating in Nevada, except a sole proprietor with no employees, to have a business license issued by the Department of Taxation. Nevada law defines a "business" to include a corporation, partnership, proprietorship, business association and other similar organization that conducts an activity for profit.<sup>23</sup>

#### **SALES TAX PERMIT**

Most businesses that sell tangible personal property (such as merchandise) must get a seller's permit from the Nevada Tax Commission. Applications for a Sales and Use Tax Permit must be made on a Form ST-1 and must be accompanied by a fee, plus a security deposit on Form ST-2A. Security deposits, if required, may be made by the following:

- 1) Cash deposits
- 2) Surety bonds (Form ST-2A)
- 3) Corporate or personal surety
- 4) Certificates of deposits, including time certificates, passbook savings accounts or certain other certificates the Tax Commission agrees to accept.
- 5) Negotiable U.S. savings certificates or U.S. savings bonds
- 6) Pledge and lien on real property

The amount of deposit, if any, will usually be a function of the projected quarterly sales based on an estimate of monthly sales given in the registration form.

Sellers (or users) must file monthly returns and pay the tax on or before the last day of the following month. If sales do not exceed \$10,000, the returns may be filed quarterly.

#### **BUSINESS PERSONAL PROPERTY TAX STATEMENT**

A Business Personal Property Tax Statement must be filed with the county assessor when requested or by December 31.

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<sup>23</sup> NRS §364A.020, *et. seq.*

## **FICTITIOUS BUSINESS NAMES**

Nevada Law requires that every person who regularly transacts business in the state for profit under a fictitious business name must file and publish a fictitious business name certificate. If a fictitious name is used, a fictitious business name certificate must be filed within one month with the county clerk of each county where the business uses the name.

## **FEDERAL ISSUES**

### **SOCIAL SECURITY TAX AND FEDERAL INCOME TAX WITHHOLDING**

The first thing a new business must do is apply for a federal Employer Identification Number. The Form SS-4 should be filed as soon as possible if the business has employees. Even if they have no employees, corporations, LLCs and partnerships are required to file Form SS-4.

It is a good idea for a business with employees to obtain a business tax kit from the local IRS office. Also helpful is Circular E, Employer's Tax Guide, an IRS publication that explains federal income tax withholding and social security tax requirements for employers.

The withheld federal income tax, withheld employee social security tax, and employer's social security tax are all lumped together and paid over to the government at the same time. Generally, businesses deposit the taxes with a federal tax deposit form and a precoded coupon at an authorized commercial bank.

When a new employee is hired, the business must furnish the employee with a federal form W-4 which must be completed and returned to the business. The W-4 will provide the employer-business with the employee's Social Security number and the number of withholding exemptions the employee is claiming. This information is used to determine the amount of income tax withheld from the employee's wages.

By January 31 of each year, the business must provide the employee with copies of Form W-2, Annual Wage and Tax Statement, showing the taxable wages paid to the employee during the preceding calendar year and the taxes withheld. By the last day of February, the original of each W-2 and a summary form (W-3) should be filed with the IRS.

If the business hires independent contractors for some of its work and the independent contractor is paid \$600 or more during the preceding calendar year, the business must provide the independent contractor with a Form 1099 by January 31.

## **GENERAL ISSUES**

### **INSURANCE**

For almost any business, even one that has no employees, insurance coverage for general liability, product liability, fire and similar disasters, robbery, theft, and interruption of business should be considered.

If the business will have employees, Worker's Compensation insurance is mandatory in Nevada and employee's life, health, and disability insurance are virtual necessities in many businesses and

professions, if the business wishes to be competitive with other firms in hiring and retaining capable employees.

Fidelity bonding should be considered for employees who will have access to the cash receipts or other funds of the business. If the business has an employee's pension or profit sharing plan subject to ERISA<sup>24</sup>, employees involved in administering the plan or handling its funds must be covered by a fidelity bond, under ERISA.<sup>25</sup>

### **EMPLOYMENT CONTRACTS**

If the business employs people who are privy to trade secrets or other confidential information, it is highly desirable for the business to have the employee sign an agreement not to disclose such information either while they are employed by the business or after their employment has been terminated. This agreement should be signed and included in the employee's personnel file.

Likewise, another important aspect of an employment contract is its ability to prevent an employee from going to work for a competitor or setting up a competing business. It is important that a noncompetition agreement be reasonable regarding the restraints imposed or it may be deemed unenforceable.

### **BUY/SELL AGREEMENT**

If the business has more than one owner, it is important for the owners to enter into a buy/sell agreement that spells out what happens if one of the owners dies, becomes disabled, or wants to sell his or her interest in the business.

Often these agreements are "funded" by life insurance on the owners, so that if an owner dies, the business or the other owners will collect the life insurance proceeds and use those funds to buy out the deceased owner's interest in the business.

Many small business owners ignore the need for buy/sell agreements or keep putting it off. However, just like a will, when the agreement is needed, it may be too late.

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<sup>24</sup> Employee Retirement Income Security Act of 1974.

<sup>25</sup> 29 U.S.C.A. §1112 (Sec. 412 of ERISA).

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**CHECKLIST OF REQUIREMENTS FOR ALMOST ALL NEW BUSINESSES**

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- Obtain state and local business licenses.
- Check on local zoning ordinances, regulations, and other land use restrictions.
- Determine if your particular business requires a special state license to operate.
- Determine whether any type of federal permit or license is required.
- Be prepared to make estimated income tax payments almost immediately after starting business or incorporating.
- Apply for a sales and use tax seller's permit if you will sell tangible personal property.
- File sales and use tax returns, if sales or use tax must be collected on your sales.
- File with the county clerk and publish a fictitious business name statement if the business operates under a fictitious name.
- Locate a good insurance agent or retain and meet with an insurance consultant regarding fire, accident, liability, theft and other types of commercial insurance you need. Then obtain the necessary insurance coverage.
- For a sole proprietorship, report any self-employment income on Schedule SE of federal Form 1040, and report income or loss on Schedule C of Form 1040.
- A partnership files Form 1065 reporting partnership income. Each partner reports his or her share of self-employment income on Schedule SE of Form 1040 and income or loss from partnership operations on Schedule E of Form 1040.
- For a limited partnership, file a Certificate of Limited Partnership with the Secretary of State and copies in counties where the partnership has places of business or real estate (in most states).
- For a corporation, file articles of incorporation, adopt bylaws, and observe necessary corporate formalities. File federal income tax return Form 1120 (1120-S for an S-Corp).
- For an S-Corp, timely file the S-Corp election (IRS Form 2553).
- For a corporation, partnership or limited liability company, apply for a federal employer identification number on form SS-4, even if the business has no employees.
- File annual tax information returns,